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No. 347

In the Supreme Court of the United States

OCTOBER TERM, 1950

UNITED STATES OF AMERICA, PETITIONER

v.

ELLIS R. LEWIS

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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The Solicitor General, on behalf of the United States, prays that a writ of certiorari issue to review the judgment of the United States Court of Claims entered in this case.

OPINION BELOW

The special findings of fact, conclusions of law, and opinion of the Court of Claims (R. 5-11) together with the dissenting opinion of Judge Whitaker (R. 11-13) are not yet reported.

JURISDICTION

The judgment of the Court of Claims was entered on July 10, 1950. (R. 13.) The jurisdiction of

this Court is invoked under 28 U.S.C., Section 1255(1).

QUESTION PRESENTED

During the year 1944, respondent received from his employer compensation consisting of salary and bonus. However, pursuant to a court judgment in the year 1946, he was obliged to return a portion of the bonus to the employer. Was the amount thus returned to the employer properly included in respondent's taxable income for the year 1944?

STATUTE INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 22.)

STATEMENT

During the year 1944 and for some years prior thereto, taxpayer (respondent) was vice president, a member of the board of directors and general manager of the Accurate Spring Manufacturing Company. In 1944 he directed the policies of the company and was in active charge of its entire operations, including the hiring and discharging of employees, execution of contracts, and signing of checks together with the bookkeeper and assistant treasurer of the company. During that year the president of the company was in Florida and did not participate substantially in the management of the business. (R. 5-6.)

In December 1938, it was agreed between the taxpayer and the president that, in addition to a stated salary, taxpayer would receive a bonus of ten per cent of the net profits of the company before deduction for taxes. For the years 1939 and 1940 taxpayer was paid on that basis. Late in 1941 the president discussed with the taxpayer the matter of the latter's bonus because of the large amount of compensation he would receive on the existing basis due to the substantial increase in the company's profits. It was decided at that time, however, that no change would be made until after the profits for 1941 had been determined. (R. 6.)

In the early part of 1942, after the profits for 1941 had been determined, the taxpayer was presented with a statement based on computations of

the bonus both before and after deduction for taxes. Taxpayer agreed to accept for that year a bonus computed after deduction for taxes, and his compensation for 1941 was paid on that basis. Without further agreement between the parties, taxpayer's compensation for the years 1942 and 1943 was similarly paid on the same basis. (R. 6.)

For the year 1944, and without further discussion or agreement as to the basis of his compensation, taxpayer directed the payment to himself of a bonus on the basis of a computation on profits *before* deduction for taxes. On this basis taxpayer received a bonus of $21,924. At that time taxpayer believed that he was entitled to have his bonus computed on that basis, notwithstanding the acceptance by him of the bonuses for 1941, 1942 and 1943 on the basis of profits after deduction for taxes. (R. 6.)

The company in its income tax return for 1944, filed March 1945, deducted as part of the compensation paid to officers the sum of $21,924 paid to taxpayer and paid its income tax accordingly. Later, in 1945, the company filed an amended return in which it deducted as bonus compensation to taxpayer only the sum of $11,067.94 and paid the additional tax resulting from the recomputation. (R. 6.)

Some time after the company's return for 1944 had been filed, taxpayer was discharged from his position, and he subsequently brought suit in an

Illinois state court against the company for additional compensation for the year 1944, claiming among other things that by reason of improper deductions of expense items the profits before taxes were stated too low and that he should have received a larger bonus for that year. The company filed a counterclaim in which it claimed that the taxpayer had acted improperly in directing payment to himself of a bonus computed on profits before taxes for the year 1944, and that by such improper action he had received an excessive bonus. At the trial the taxpayer testified that the agreement was to pay a bonus based on profits before taxes. (6-7, 8-9.)

On December 3, 1946, judgment was entered against taxpayer. The court found that under the agreement between taxpayer and the company the taxpayer was entitled to receive for the year 1944 a bonus computed on the profits of the company after deduction for taxes, notwithstanding that taxpayer mistakenly believed that the bonus was to have been computed on the net profits before deduction for taxes. The court found that by virtue of this mistake taxpayer had received for the year 1944 the sum of $10,856.06 in excess of the amount to which he was entitled. Taxpayer repaid that amount to the company in 1946. (R. 7.)

On or about March 15, 1945, and November 7, 1945, respectively, the taxpayer filed original and amended income tax returns for the calendar year

1944, and duly paid the total tax of $18,098.99 disclosed therein. (R. 7.) Included in the taxable income shown on taxpayer's amended return was the $21,924 received as a bonus from the company based upon a percentage of the net profits before taxes. (R. 7.)

Later, taxpayer filed with the appropriate Collector of Internal Revenue a timely claim for refund for the year 1944, basing such claim upon the exclusion from his taxable net income, as reported, of the sum of $10,856.06 which the state court had decreed was improperly paid to taxpayer by the company. (R. 7.) After rejection of the claim by the Commissioner (R. 7), proceedings were instituted in the Court of Claims to recover the refund sought (R. 1-4.) The Court of Claims entered judgment for the taxpayer. (R. 13.)

REASONS FOR GRANTING THE WRIT

This case presents the familiar situation where a taxpayer receives income in a given year and pays the appropriate tax thereon, but in a subsequent year, because of unforseen contingencies, he is obliged to restore a portion of such income to the payor. This poses the question as to whether the income should be adjusted in the year of receipt or in the year in which restitution is made.

1. The decision below is wrong. The court, Judge Whitaker dissenting, erroneously held "that when a taxpayer receives money which he supposes

he is entitled to keep, and pays income tax on it, but later learns that he was mistaken in thinking he was entitled to keep it, and pays it back, he is entitled to a refund from the Government of the tax paid on it." (R. 9.) There is no basis in the income tax law or the decided cases to support such a holding.

In *North American Oil* v. *Burnet*, 286 U. S. 417, this Court specifically stated that (p. 424):

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

This rule, which has come to be known as the "claim of right" doctrine, has been followed by lower federal courts in many cases, including *Commissioner* v. *Alamitos Land Co.*, 112 F. 2d 648 (C. A. 9), certiorari denied, 311 U. S. 679; *Penn* v. *Robertson*, 115 F. 2d 167 (C. A. 4); *Saunders* v. *Commissioner*, 101 F. 2d 407 (C. A. 10); *Griffin* v. *Smith*, 101 F. 2d 348 (C. A. 7); *Board* v. *Commissioner*, 51 F. 2d 73 (C. A. 6), certiorari denied, 284 U. S. 658; *United States* v. *Commerford*, 64 F. 2d 28 (C. A. 2), certiorari denied, 289 U. S. 759; *Barker* v. *Magruder*, 95 F. 2d 122 (C. A. D. C.); *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 47 F. 2d 990 (C. A. 7), certiorari denied, 284 U. S. 618.

The Court of Claims applied the doctrine in a *per curiam* opinion in *Schramm* v. *United States*, 93 C. Cls. 181.

There is no essential difference between the present case and those above cited. In each instance the taxpayer received income under a claim of right and without restriction as to its disposition or use. Here the taxpayer believed at the time that he was entitled to receive the bonus paid to him in 1944, and the court below so found. (R. 7.) Furthermore, after the taxpayer was discharged from his position in 1945, he instituted suit in an Illinois court against his former employer claiming that he was entitled to an even larger amount of bonus for the year 1944. A counterclaim by the company based on the assertion that the bonus paid to the taxpayer in 1944 was excessive (R. 6-7, 8-9) was sustained by the court and then, for the first time, the obligation to repay the excess compensation arose. At the trial and at all times prior to the judgment of the Illinois court, the taxpayer insisted that he was entitled to the bonus originally paid him in 1944. (R. 8-9.) Under the rule of *North American Oil* and the cases following it, the bonus received by taxpayer in 1944 was properly taxed to him in that year. Accordingly, the decision of the Court of Claims in the instant case violates a well-established doctrine of federal tax law, and, as the Court of Claims itself recognizes (R. 14), creates a clear conflict of decisions among the lower federal courts.

The deviation by the Court of Claims from the so-called "claim of right" doctrine had its inception in *Greenwald* v. *United States*, 102 C. Cls. 272, where the court concluded that because a bonus received by the taxpayer was based upon an improper computation of net income which resulted in the payment of a bonus in excess of that to which he was entitled, the doctrine should not be applied. In a later case, *Gargaro* v. *United States*, which was first decided on demurrer (109 C. Cls. 528) and later on the merits (114 C. Cls. 704), the net income of the corporation which paid the bonus was reduced in a subsequent year by reason of renegotiation proceedings. The court again held for the taxpayer.

In its opinion in the present case (R. 9-10), the Court of Claims erroneously relied upon *Commissioner* v. *Wilcox*, 327 U. S. 404, to support its holding. The *Wilcox* case, however, involved the tax liability of an embezzler and in determining that the amount embezzled was not income for tax purposes, this Court stressed the fact that the embezzler had not received the money under a claim of legal right and was at all times under the undenied obligation to restore it to its rightful owner. Obviously, that case merely holds, on the facts there presented, that the "claim of right" doctrine was inapplicable. It not only does not support the holding below, but indeed provides further proof of this Court's acceptance of the "claim of right"

doctrine. Compare *Akers* v. *Scofield*, 167 F. 2d 718 (C. A. 5), certiorari denied, 335 U. S. 823, which involved a "gold brick" swindler. The court determined that the amount received as a result of the swindle was taxable because it had been received by the taxpayer as his own under a claim of right and without any restriction upon its disposition or use.

2. An issue of considerable importance in the administration of the income tax law is thus presented in the instant case. The "claim of right" doctrine established in the *North American Oil* case, *supra*, is merely an application of a fundamental principle of tax law, namely, that tax accounting must be on an annual basis because of the practical necessity for determining revenues on such basis. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359; *Heiner* v. *Mellon*, 304 U. S. 271; *Brown* v. *Helvering*, 291 U. S. 193, 199; *National City Bank of New York* v. *Helvering*, 98 F. 2d 93 (C. A. 2). If the contrary doctrine laid down by the Court of Claims should be permitted to stand, a taxpayer could withhold the payment of taxes on income for an indefinite period in order to await final determination, whenever in the future it should come, whether such income really is his and can without question be retained by him. Clearly, such a proposition would, if accepted, wreak havoc with the revenue.

3. As has already been mentioned, the decision below is in conflict with numerous decisions of this

Court and of lower federal courts throughout the country. It is also in express conflict with a recent case, *Haberkorn* v. *United States,* 173 F. 2d 587 (C. A. 6), which was decided March 28, 1949, subsequent to the decision by the Court of Claims in *Gargaro* v. *United States, supra.* In applying the "claim of right" doctrine in the *Haberkorn* case, the court expressed disagreement with the decisions of the Court of Claims in the *Greenwald* and *Gargaro* cases, *supra.* And, in its opinion in the instant case, the Court of Claims referring to the *Haberkorn* decision, stated that it was "aware that * * * the Sixth Circuit has, upon similar facts, reached a contrary conclusion." R. 11.)

CONCLUSION

This petition for a writ of certiorari should be granted.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

OCTOBER, 1950.

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